MegaFon

Interim condensed consolidated financial statements
(Unaudited)

For the six months ended 30 June 2014

Contents

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Report on review of interim condensed consolidated financial statements

The Board of Directors and Shareholders
OJSC MegaFon

Introduction

We have reviewed the accompanying interim condensed consolidated financial statements of Open Joint Stock Company MegaFon and its subsidiaries ("the Company"), comprising the interim condensed consolidated statement of financial position as at 30 June 2014 and the related interim condensed consolidated statements of comprehensive income for the three and six-month periods then ended, the related interim condensed consolidated statements of changes in equity and cash flows for the six-month period then ended and explanatory notes. Management is responsible for the preparation and presentation of these interim condensed consolidated financial statements in accordance with International Financial Reporting Standard IAS 34, *Interim Financial Reporting* ("IAS 34"). Our responsibility is to express a conclusion on these interim condensed consolidated financial statements based on our review.

Scope of review

We conducted our review in accordance with the International Standard on Review Engagements 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*. A review of interim financial statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim condensed consolidated financial statements are not prepared, in all material respects, in accordance with IAS 34.

Ernst & Young LLC

30 July 2014

Interim condensed consolidated statement of comprehensive income

(In millions of Rubles)

	Note	Three months ended 30 June 2014	2013	Six months ended 30 June 2014	2013
		(Unaudited)		(Unaudited)	
Revenues					
Wireless services		66,308	63,570	131,027	123,173
Wireline services		5,390	4,673	10,684	9,195
Sales of equipment and accessories		4,968	3,987	9,831	7,586
Total revenues		**76,666**	**72,230**	**151,542**	**139,954**
Operating expenses					
Cost of services		14,971	13,865	29,666	26,549
Cost of equipment and accessories		4,687	3,865	9,865	6,969
Sales and marketing expenses	10	3,875	4,119	7,743	7,021
General and administrative expenses	11	18,835	16,079	37,467	32,732
Depreciation		11,809	11,068	23,726	22,355
Amortisation		1,972	1,378	4,018	2,724
Loss on disposal of non-current assets	7	347	108	489	245
Total operating expenses		**56,496**	**50,482**	**112,974**	**98,595**
Operating profit		**20,170**	**21,748**	**38,568**	**41,359**
Finance costs	8	(3,893)	(2,808)	(7,445)	(5,574)
Finance income		419	769	461	1,187
Share of loss of associates and joint ventures		(396)	(41)	(668)	(186)
Other non-operating (expense)/income	13	(822)	(29)	(1,127)	39
Gain on financial instruments		899	130	961	56
Foreign exchange gain/(loss), net		1,579	(2,228)	(3,296)	(3,044)
Profit before tax		**17,956**	**17,541**	**27,454**	**33,837**
Income tax expense	12	4,026	3,915	6,249	7,570
Profit for the period		**13,930**	**13,626**	**21,205**	**26,267**

The accompanying notes are an integral part of these interim condensed consolidated financial statements.

Interim condensed consolidated statement of comprehensive income (continued)

(In millions of Rubles, except per share amounts)

	Three months ended 30 June 2014 (Unaudited)	Three months ended 30 June 2013 (Unaudited)	Six months ended 30 June 2014 (Unaudited)	Six months ended 30 June 2013 (Unaudited)
Other comprehensive income/(loss)				
Other comprehensive income/(loss) to be reclassified to profit or loss in subsequent periods:				
Foreign currency translation difference, net of tax of nil	294	(105)	(18)	(182)
Net movement on cash flow hedges, net of tax	18	135	108	135
Net other comprehensive income/(loss) to be reclassified to profit or loss in subsequent periods	**312**	**30**	**90**	**(47)**
Total comprehensive income for the period, net of tax	**14,242**	**13,656**	**21,295**	**26,220**
Profit for the period				
Attributable to equity holders of the Company	13,886	13,581	21,114	26,205
Attributable to non-controlling interest	44	45	91	62
Total comprehensive income for the period				
Attributable to equity holders of the Company	14,129	13,637	21,223	26,203
Attributable to non-controlling interest	113	19	72	17
Earnings per share, Rubles				
Basic, profit for the period attributable to ordinary equity holders of the Company	24	24	37	46
Diluted, profit for the period attributable to ordinary equity holders of the Company	24	23	36	45

The accompanying notes are an integral part of these interim condensed consolidated financial statements.

MegaFon

Interim condensed consolidated statement of financial position

(In millions of Rubles)

	Note	30 June 2014 (Unaudited)	31 December 2013 Restated* (Audited)
Assets			
Non-current assets			
Property and equipment	7	216,277	220,272
Intangible assets, other than goodwill		56,312	58,848
Goodwill		32,066	31,899
Investments in associates and joint ventures		34,792	35,460
Non-current financial assets	8	856	425
Non-current non-financial assets		1,402	1,300
Deferred tax assets		3,839	3,673
Total non-current assets		**345,544**	**351,877**
Current assets			
Inventory		7,973	8,376
Current non-financial assets		5,661	5,960
Prepaid income taxes		4,607	2,777
Trade and other receivables		12,469	10,732
Other current financial assets	8	4,939	39,296
Cash and cash equivalents		47,038	9,939
Total current assets		**82,687**	**77,080**
Assets held for sale		1,194	1,516
Total assets		**429,425**	**430,473**
Equity and liabilities			
Equity			
Equity attributable to equity holders of the Company		121,518	138,034
Non-controlling interests		294	271
Total equity		**121,812**	**138,305**
Non-current liabilities			
Loans and borrowings	8	131,267	130,825
Other non-current financial liabilities	4,8	5,101	20,838
Non-current non-financial liabilities		1,238	1,170
Provisions		5,742	5,355
Deferred tax liabilities		18,650	17,752
Total non-current liabilities		**161,998**	**175,940**
Current liabilities			
Trade and other payables		25,889	33,875
Dividends payable	5	38,428	—
Loans and borrowings	8	38,632	21,184
Other current financial liabilities	4,8	22,617	40,785
Current non-financial liabilities		19,347	19,490
Income taxes payable		702	894
Total current liabilities		**145,615**	**116,228**
Total equity and liabilities		**429,425**	**430,473**

** Certain amounts do not correspond to the 2013 financial statements and reflect adjustments made, refer to Note 4.*

The accompanying notes are an integral part of these interim condensed consolidated financial statements.

Interim condensed consolidated statement of changes in equity

(In millions of Rubles)

For the six months ended 30 June 2014 and 30 June 2013

		Attributable to equity holders of the Company									
		Ordinary shares		Treasury shares							
	Note	**Number of shares**	**Amount**	**Number of shares**	**Amount**	**Capital surplus**	**Retained earnings**	**Other capital reserves**	**Total**	**Non-controlling interests**	**Total equity**
As of 1 January 2013		**620,000,000**	**526**	**54,690,089**	**(39,133)**	**12,567**	**143,468**	**(73)**	**117,355**	**518**	**117,873**
Net profit		—	—	—	—	—	26,205	—	26,205	62	26,267
Other comprehensive loss		—	—	—	—	—	—	(2)	(2)	(45)	(47)
Total comprehensive income							**26,205**	**(2)**	**26,203**	**17**	**26,220**
Share-based compensation	9	—	—	—	—	—	—	808	808	—	808
Sale of treasury shares upon exercise of stock options	9	—	—	(7,750,000)	5,545	—	(676)	—	4,869	—	4,869
Dividends	5	—	—	—	—	—	(36,968)	—	(36,968)	—	(36,968)
Dividends to non-controlling interests		—	—	—	—	—	—	—	—	(49)	(49)
As of 30 June 2013 (unaudited)		**620,000,000**	**526**	**46,940,089**	**(33,588)**	**12,567**	**132,029**	**733**	**112,267**	**486**	**112,753**
As of 1 January 2014		**620,000,000**	**526**	**46,940,089**	**(33,588)**	**12,567**	**157,986**	**543**	**138,034**	**271**	**138,305**
Net profit		—	—	—	—	—	21,114	—	21,114	91	21,205
Other comprehensive income/(loss)		—	—	—	—	—	—	109	109	(19)	90
Total comprehensive income							**21,114**	**109**	**21,223**	**72**	**21,295**
Share-based compensation	9	—	—	—	—	—	—	689	689	—	689
Dividends	5	—	—	—	—	—	(38,428)	—	(38,428)	—	(38,428)
Dividends to non-controlling interests		—	—	—	—	—	—	—	—	(49)	(49)
As of 30 June 2014 (unaudited)		**620,000,000**	**526**	**46,940,089**	**(33,588)**	**12,567**	**140,672**	**1,341**	**121,518**	**294**	**121,812**

MegaFon

Interim condensed consolidated statement of cash flows

(In millions of Rubles)

	Note	Six months ended 30 June 2014 (Unaudited)	2013
Operating activities			
Profit before tax		27,454	33,837
Non-cash adjustments to reconcile profit before tax to net operating cash flows:			
Depreciation		23,726	22,355
Amortisation		4,018	2,724
Loss on disposal of non-current assets		489	245
Gain on financial instruments		(961)	(56)
Net foreign exchange loss		3,296	3,044
Share of loss of associates and joint ventures		668	186
Change in impairment allowance for receivables		764	481
Finance costs		7,445	5,574
Finance income		(461)	(1,187)
Share-based compensation		689	808
Other non-operating expense/(income)		1,127	(39)
Working capital adjustments:			
Decrease/(increase) in inventory		409	(1,409)
Increase in trade and other receivables		(2,998)	(1,398)
Decrease/(increase) in current non-financial assets		278	(8)
Decrease in trade and other payables		(4,313)	(420)
Decrease in current non-financial liabilities		(3,295)	(1,834)
Change in VAT, net		2,194	(316)
Income tax paid		(7,437)	(6,216)
Income tax refunded		172	2,189
Interest received		399	462
Interest paid, net of interest capitalised		(5,809)	(4,330)
Net cash flows from operating activities		**47,854**	**54,692**
Investing activities			
Purchase of property, equipment and intangible assets		(27,429)	(14,373)
Proceeds from sale of property and equipment		526	117
Acquisition of subsidiaries, net of cash acquired	7	(146)	—
Payment of deferred consideration for Scartel	4	(36,330)	—
Net change in short-term demand deposits		39,459	(24,428)
Net cash flows used in investing activities		**(23,920)**	**(38,684)**
Financing activities			
Proceeds from borrowings, net of fees paid		23,158	26,153
Repayment of borrowings		(5,943)	(24,561)
Payment of liability for marketing related licences		(184)	(299)
Dividends paid to non-controlling interests		(49)	(49)
Proceeds from exercise of stock options		—	4,869
IPO transaction fees paid		—	(212)
Other		—	403
Net cash flows from financing activities		**16,982**	**6,304**
Net increase in cash and cash equivalents		40,916	22,312
Net foreign exchange difference		(3,817)	221
Cash and cash equivalents at beginning of period		9,939	2,387
Cash and cash equivalents at end of period		**47,038**	**24,920**

The accompanying notes are an integral part of these interim condensed consolidated financial statements.

1. General

Open Joint Stock Company MegaFon ("MegaFon", the "Company" and together with its consolidated subsidiaries the "Group") is a leading universal telecommunications operator in Russia and provides a broad range of voice, data and other telecommunications services to retail customers, businesses, government clients and other telecommunications services providers.

In November 2012, MegaFon completed an initial public offering ("IPO") and listed its ordinary shares on the Moscow Exchange and its ordinary shares represented by Global Depositary Receipts, or GDRs, on the London Stock Exchange, in each case under the symbol ''MFON''.

2. Basis of preparation

These interim condensed consolidated financial statements have been prepared in accordance with IAS 34, *Interim Financial Reporting*, and should be read in conjunction with the annual consolidated financial statements of the Group for the year ended 31 December 2013.

These interim condensed consolidated financial statements are unaudited and do not include all the information and disclosures required in the annual IFRS financial statements. The Company omitted disclosures which would substantially duplicate the information contained in its 2013 audited consolidated financial statements, such as accounting policies and details of accounts which have not changed significantly in amount or composition. Additionally, the Company has provided disclosures where significant events have occurred subsequent to the issuance of its 2013 audited consolidated financial statements. Management believes that the disclosures in these interim condensed consolidated financial statements are adequate to make the presented information not misleading if these interim condensed consolidated financial statements are read in conjunction with the Group's 2013 audited consolidated financial statements and the notes related thereto. In the opinion of management, the financial statements reflect all adjustments necessary to present fairly the Group's financial position, financial performance and cash flows for the interim reporting periods in accordance with IAS 34, *Interim Financial Reporting*.

The interim condensed consolidated financial statements are presented in millions of Rubles, except for per share amounts which are in Rubles, unless otherwise indicated.

The interim condensed consolidated financial statements were authorised for issue by the Company's Chief Executive Officer ("CEO") and Chief Accountant on 30 July 2014.

3. Significant accounting policies

The accounting policies and methods of computation applied in the preparation of these interim condensed consolidated financial statements are consistent with those disclosed in the annual consolidated financial statements of the Group for the year ended 31 December 2013, except for the adoption of new standards and interpretations effective from 1 January 2014.

4. Scartel settlement and measurement period adjustments

On 24 June 2014, the Company prepaid in cash approximately 90% of the deferred consideration due to Garsdale Investment Services Limited ("Garsdale") for the acquisition of Scartel, including principal and accrued interest, in the amount of 37,925.

The net assets recognised in the 31 December 2013 financial statements were based on a provisional assessment of their fair value while the Group sought an independent valuation for the tangible and intangible assets of Scartel. In June 2014, the valuation of certain assets was updated and the acquisition date fair value of the assets changed as follows:

	Provisional amounts	**Measurement period adjustments**	**Updated provisional amounts**
Property and equipment	13,833	(1,533)	12,300
Intangible assets	43,315	1,072	44,387
Goodwill	7,566	369	7,935
Deferred tax liabilities	(5,886)	92	(5,794)

The 2013 comparative information was restated to reflect the adjustment to the provisional amounts. The respective changes in depreciation and amortisation charges from the acquisition date to 31 December 2013 and 30 June 2014 were not material.

As of 30 July 2014 the Group's management continues to evaluate the fair value of certain assets of Scartel as well as allocation of Scartel's goodwill to cash generating units.

5. Dividends

On 30 June 2014, the Annual General Meeting of Shareholders of the Company approved a final dividend for 2013 financial year in the amount of 64.51 Rubles per ordinary share (or GDR). After taking into account the interim dividend for the first quarter of 2013 paid in 2013, total dividends for 2013 amount to 74.85 Rubles per ordinary share (or GDR). The total sum allocated to the dividend payment is 38,428.

6. Segment information

The Group manages its business primarily based on eight geographical operating segments within Russia, which provide a broad range of voice, data and other telecommunication services, including wireless and wireline services to clients, interconnection services, data transmission services and value added services ("VAS"). The Chief Operating Decision Maker ("CODM") evaluates the performance of the Group's operating segments based on revenue and operating income before depreciation and amortisation ("OIBDA"). Total assets and liabilities are not allocated to operating segments and not analysed by the CODM. Operating segments with similar economic characteristics have been aggregated into an integrated telecommunication services segment, which is the only reportable segment. Less than 1% of the Group's revenues and results are generated by segments outside of Russia. No single customer represents 10% or more of the consolidated revenues.

6. Segment information (continued)

Reconciliation of consolidated OIBDA to consolidated profit before tax for the three and six months ended 30 June:

	Three months ended 30 June		Six months ended 30 June	
	2014	**2013**	**2014**	**2013**
OIBDA	**34,298**	**34,302**	**66,801**	**66,683**
Depreciation	(11,809)	(11,068)	(23,726)	(22,355)
Amortisation	(1,972)	(1,378)	(4,018)	(2,724)
Loss on disposal of non-current assets	(347)	(108)	(489)	(245)
Finance costs	(3,893)	(2,808)	(7,445)	(5,574)
Finance income	419	769	461	1,187
Share of loss of associates and joint ventures	(396)	(41)	(668)	(186)
Other non-operating (expense)/income	(822)	(29)	(1,127)	39
Gain on financial instruments	899	130	961	56
Foreign exchange gain/(loss), net	1,579	(2,228)	(3,296)	(3,044)
Profit before tax	**17,956**	**17,541**	**27,454**	**33,837**

Seasonality of operations

The Company’s services are impacted by seasonal trends throughout the year. Higher revenues and operating profits are usually expected in the second half of the year rather than in the first six months. Higher revenues during the period July to September are mainly attributed to the increased demand for telecommunication services during the peak holiday season. Higher revenues also occur in the month of December, due to increased demand for telecommunication services and equipment from private customers. Also the number of working days is significantly higher in the second half of a calendar year than in the first half of the year due to long public holidays in January and May in Russia, which also contributes to higher revenues in the second half of the year. This information is provided to allow for a better understanding of the results; however, management has concluded that this does not constitute ’highly seasonal’ as considered by IAS 34.

7. Property and equipment and other investments

During the six months ended 30 June 2014, the Group acquired assets with a cost of 20,140 (30 June 2013: 11,328). Assets (other than those classified as held for sale) with a net book value of 491 were disposed of by the Group during the six months ended 30 June 2014 (30 June 2013: 330), resulting in a net loss on disposal of 423 (30 June 2013: 245). Interest capitalised was 835 and 669 for the six months ended 30 June 2014 and 2013, respectively.

On 5 February 2014, the Group acquired 100% of the shares of LLC Tele MIG, a wireline operator and internet-provider in Novyi Urengoy region, for cash consideration of 110 and contingent consideration of 10. The aggregate 120 consideration has been allocated mainly between goodwill of 110 and tangible assets.

7. Property and equipment and other investments (continued)

On 30 June 2014, the Group acquired 100% of the shares of LLC Aston, a wireline operator and internet-provider in Moscow region, for cash consideration of 60. The consideration has been allocated mainly between goodwill of 38 and tangible assets.

8. Financial assets and liabilities

New derivative financial instrument

In March 2014 the Company entered into a cross-currency swap agreement with a notional amount of $243 million (8,172 at the exchange rate as of 30 June 2014) that limits its exposure from changes in foreign currency exchange rates on certain long-term debt.

The terms of the swap agreement did not meet the requirements for hedge accounting, therefore the Group has reported all gains and losses from the change in fair value of this derivative financial instrument directly in the consolidated statement of comprehensive income. Total loss recorded in profit and loss in respect of the derivative was 388 for the period ended 30 June 2014.

Fair values

Management has determined that cash, short-term deposits, trade receivables, trade payables, bank overdrafts and other current liabilities approximate their carrying amounts largely due to the short-term maturities of these instruments.

The Group, using available market information and appropriate valuation methodologies, where they exist, has determined the estimated fair values of its financial instruments. However, judgment is necessarily required to interpret market data to determine the estimated fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Group could realise in a current market exchange.

While management has used available market information in estimating the fair value of its financial instruments, the market information may not be fully reflective of the value that could be realised in the current circumstances.

Fair values of the Group's loans and borrowings and other liabilities carried at amortised cost, except for market quoted Ruble bonds, are determined by a discounted cash flow method using a discount rate that reflects the issuer's borrowing rate as at the end of the reporting period. The own nonperformance risk as at 30 June 2014 and 31 December 2013 was assessed to be insignificant.

The fair value of the Group's assets held for sale (Level 3), which mainly consists of an office building in Saint Petersburg, is determined based on real estate transaction prices observed in the market and approximates their carrying value at 30 June 2014 (31 December 2013: 1,851).

During the six months ended 30 June 2014 there were no transfers between levels of the fair value hierarchy.

The Group, in connection with its current activities, is exposed to various financial risks, such as foreign currency risks, interest rate risks and credit risks. The Group manages these risks and monitors their exposure on a regular basis.

8. Financial assets and liabilities (continued)

Set out below is a comparison by class of the carrying amounts and fair values of the Group's financial instruments that are carried in the financial statements.

		Carrying amount		Fair value	
		30 June 2014 (Unaudited)	**31 December 2013**	**30 June 2014 (Unaudited)**	**31 December 2013**
Financial assets					
Financial assets at fair value through profit or loss:					
Euroset settlement put option	Level 3	1,611	1,176	1,611	1,176
Cross-currency swap not designated as hedge	Level 2	638	300	638	300
Financial assets at fair value through OCI:					
Cross-currency swap designated as cash flow hedge	Level 2	218	125	218	125
Loans and receivables at amortised cost:					
Short-term bank deposits	Level 3	3,328	38,120	3,328	38,120
Total financial assets		**5,795**	**39,721**	**5,795**	**39,721**
Financial liabilities					
Financial liabilities at amortised cost:					
Loans and borrowings	Level 3	124,899	122,009	128,200	125,190
Ruble bonds	Level 1	45,000	30,000	44,965	29,980
Convertible debt instrument (Due to Garsdale for Euroset)	Level 2	22,028	20,678	22,028	20,678
Liability for marketing related licences	Level 3	—	177	—	177
Long-term accounts payable	Level 3	931	950	931	950
Deferred consideration for Scartel	Level 3	4,216	39,198	4,216	39,198
Financial liabilities at fair value through profit or loss:					
Cross-currency swap not designated as hedge	Level 2	311	—	311	—
Financial liabilities at fair value through OCI:					
Interest-rate swaps designated as cash flow hedges	Level 2	150	209	150	209
Cross-currency swaps designated as cash flow hedges	Level 2	63	128	63	128
Due to employees and related social charges, non-current	Level 2	19	283	19	283
Total financial liabilities		**197,617**	**213,632**	**200,883**	**216,793**

8. Financial assets and liabilities (continued)

The table below presents a reconciliation of the beginning and ending balances of financial instruments having fair value measurements based on significant unobservable inputs (Level 3) carried at the fair value in the financial statements for the six months ended 30 June 2014:

	Beginning balance at 1 January 2014	Line items in profit or loss	Realised gains/(losses) recognised in profit or loss	Unrealised gains/(losses) recognised in profit or loss	Settlements	**Ending balance at 30 June 2014**
Euroset settlement put option	**1,176**	Gain on financial instruments	—	435	—	**1,611**

Valuation techniques and assumptions

The fair values of interest rate swaps and cross-currency swaps are based on a forward yield curve and represent the estimated amount the Group would receive or pay to terminate these agreements at the reporting date, taking into account current interest rates, foreign exchange spot and forward rates, creditworthiness, nonperformance risk, and liquidity risks associated with current market conditions.

The Group estimated the fair value of the Euroset settlement put option using Monte Carlo simulation. The significant unobservable inputs used for the Euroset settlement put option valuation are:

Exercise date	6 December 2014
Volatility	35.4%
Risk-free rate	0.06%
Dividend yield	7.0%

Volatility and the risk-free rate are correlated with the option term: postponement of the exercise date increases the option term and, consequently, increases volatility and the risk-free rate.

In July 2014 MegaFon and Garsdale agreed on immediate exercise of the option and completed the deal accordingly *(Note 15)*. Had the information been available on 30 June 2014, the option valuation date, the option fair value would have decreased from 1,611 to nil.

Loans and borrowings

On 20 May 2014 the Group placed its Series BO-04 Ruble denominated exchange bonds, in an aggregate principal amount of 15,000. The bonds are due for repayment in full in May 2024 subject to a put option exercisable by the bondholders on the first anniversary of the placement. The coupon rate was set at 9.45% per annum, paid semiannually, and will be revised within one year from the bonds placement. The net proceeds of the bonds were used to partially repay the Scartel liability *(Note 4)*.

8. Financial assets and liabilities (continued)

In February 2014 the Group signed a new credit facility agreement with Société Générale and Nordea Bank Finland plc ("Finnvera VIII credit facility") for up to $150 million (5,045 at the exchange rate as of 30 June 2014). The Finnvera VIII credit facility must be used to finance purchases of Nokia Solutions and Networks ("NSN") equipment and services. The facility carries interest at a rate of 2.2% per annum plus bank margin. The Finnvera VIII credit facility requires the Group to make semi-annual payments, plus accrued interest, during the period from 2014 to 2022. To date, no amount has been drawn under this Finnvera VIII credit facility.

Liquidity

As of 30 June 2014 and 31 December 2013, the Group has a net current liability position. The Group believes it will continue to be able to generate significant operating cash flows and that adequate access to sources of funding and significant amount of available credit lines are sufficient to meet the Group's liquidity requirements. Additionally, the Group can defer capital expenditures if necessary in order to meet short-term liquidity requirements. Accordingly, Group management believes that cash flows from operating and financing activities will be sufficient for the Group to meet its obligations as they become due.

9. Share-based compensation

Long-term incentive programme 2013

In August 2013 the Company's Board of Directors approved a long-term motivation and retention program for certain key executive and senior level employees under which the parties selected to participate are awarded phantom share options. In the aggregate, the value ascribed to the full package of phantom share options for which options may be awarded is 1.1% of the share capital of the Company (equal to 7,000,000 phantom shares) at the base price of $24.25 per share. The plan has a three-year duration and the awarded share options vest in April-May 2015 and April-May 2016 and are settled in cash upon vesting. Payments are made on the basis of the difference between the base price and the weighted-average price of the Company's shares in the period between 15 January and 15 March of the relevant year of vesting. Vesting of the options is generally contingent upon the recipient's continuing employment with the Company.

In June 2014, a total number of 2,192,000 phantom share options were granted to certain key executive and senior level employees under the 2013 long-term incentive programme.

The fair value of options outstanding at 30 June 2014 is 220 Rubles per option. The carrying amount of the liability relating to these awards at 30 June 2014 is 32, including liability for related social charges. The employee benefits expense recognised in the six months ended 30 June 2014 in the interim condensed consolidated statement of comprehensive income is 32, including related social charges.

9. Share-based compensation (continued)

Long-term incentive programme 2012

In October 2012 the Company's Board of Directors approved a long-term motivation and retention programme for certain key executive and senior level employees under which the parties who are selected to participate are awarded phantom share options. In the aggregate, the value ascribed to the full package of phantom share options for which options may be awarded is 1.1% of the share capital of the Company (equal to 7,000,000 phantom shares) at the base price of $17.86 per share. The plan has a three-year duration and the awarded share options vest in April-May 2014 and April-May 2015 and are settled in cash upon vesting, based on the difference between the base price and the weighted-average price of the Company's shares in the period between 15 January and 15 March of the relevant year of vesting. Vesting of the options is contingent upon the recipient's continuing employment with the Group.

In February 2013 a total number of 2,133,000 phantom share options were granted to certain key executive and senior level employees under the 2012 long-term incentive programme.

In May 2014 792,400 phantom share options vested and were exercised. The weighted-average share price in the period between 15 January and 15 March 2014 was $29.80.

The fair value of options outstanding at 30 June 2014 is 425 Rubles per option. The carrying amount of the liability relating to these awards at 30 June 2014 is 337, including liability for related social charges. The employee benefits expense recognised in the six months ended 30 June 2014 in the interim condensed consolidated statement of comprehensive income is 155, including related social charges.

The respective awards under both the 2013 and 2012 long-term incentive programmes are classified as a liability. The fair value of the options has been estimated using the Monte Carlo model. The fair value of each grant is estimated at the end of each reporting period. The expected volatility was estimated based on the average historical volatility of the Company over the period equal to the expected life of the options granted. The dividend yield was included into the model based on expected dividend payments. The risk free rate was determined on the basis of U.S. Treasury yield curve rates with a remaining term to maturity equal to the expected life of the options. The expected term of the options equals their vesting term as the options are settled in cash at the end of vesting period.

The following table illustrates the major assumptions of the Monte Carlo model for the options at 30 June 2014:

Expected term, years	0.7 - 1.9
Expected volatility	30% - 32%
Expected dividend yield	7.0%
Risk free interest rate	0.10% - 0.41%

9. Share-based compensation (continued)

CEO long-term incentive plan

As part of a long-term incentive plan approved by the Company's Board of Directors in November 2012, Mr. Ivan Tavrin, the CEO of the Company, agreed to purchase, within 30 days of the Group's IPO, 7,750,000 of the Group's ordinary shares (or 1.25% of the total issued shares) at the IPO price of $20 per share. Pursuant to the plan, Mr. Tavrin was also given three options to buy up to a further 1.25% of the total issued shares on each of his employment anniversary dates in May 2013, May 2014 and May 2015 at the IPO price. The options could be exercised, in whole or in part, on those dates or subsequently, up till May 2017, when any unexercised portion will lapse. Their exercise is subject to Mr. Tavrin's continued employment with the Group and Mr. Tavrin holding at least a 1.25% interest in the Company on the relevant exercise date. Mr Tavrin exercised the first of these three options in May 2013.

On 4 March 2014 the Board of Directors of the Company agreed unanimously to amend the terms of the CEO long-term incentive plan and to accelerate the vesting of Mr. Tavrin's final two options to acquire a 1.25% interest in the Company, so that all the remaining options may now be exercised at any time after 1 May 2014. The change resulted in an additional employee benefits charge of 380 for the six months ended 30 June 2014 due to the accelerated vesting, including incremental fair value in the amount of 111 recognised during the three months ended 30 June 2014. In addition, the Board agreed to remove a restriction on Mr. Tavrin holding more than 5% of the authorised share capital of the Company at any time prior to May 2017.

10. Sales and marketing expenses

Sales and marketing expenses for the three and six months ended 30 June are as follows:

	Three months ended 30 June		**Six months ended 30 June**	
	2014	**2013**	**2014**	**2013**
Advertising	1,636	1,841	3,078	2,725
Dealer commissions	1,273	1,314	2,788	2,373
Cash collection commissions	966	964	1,877	1,923
Total sales and marketing expenses	**3,875**	**4,119**	**7,743**	**7,021**

During the six months ended 30 June 2014, advertising costs reflect the de-recognition of approximately 1,200 of amounts accrued in previous periods.

11. General and administrative expenses

General and administrative expenses for the the three and six months ended 30 June are as follows:

	Three months ended 30 June		Six months ended 30 June	
	2014	**2013**	**2014**	**2013**
Employee benefits and related social charges	7,163	6,454	14,297	13,513
Rent	3,850	3,113	7,570	6,253
Operating taxes	1,837	1,798	3,472	3,473
Network repairs and maintenance	1,546	1,252	2,919	2,513
Radio frequency fees	1,310	1,019	2,559	1,967
Utilities	1,248	1,013	2,423	2,021
Office maintenance	520	399	1,047	810
Change in allowance account for trade and other receivables	315	239	764	481
Professional services	249	191	406	453
Vehicle costs	195	163	409	311
Materials and supplies	41	35	102	93
Insurance	18	11	35	35
Other expenses	543	392	1,464	809
Total general and administrative expenses	**18,835**	**16,079**	**37,467**	**32,732**

12. Income tax

The Group calculates the period income tax expense using the tax rate that would be applicable to the expected total annual earnings.

The major components of income tax expense for the three and six months ended 30 June in the interim condensed consolidated statement of comprehensive income are as follows:

	Three months ended 30 June		Six months ended 30 June	
	2014	**2013**	**2014**	**2013**
Current income tax	2,956	4,747	5,507	7,755
Deferred income tax	1,070	(832)	742	(185)
Total income tax expense	**4,026**	**3,915**	**6,249**	**7,570**

13. Related parties

The Group is primarily owned by USM Group, an indirect controlling shareholder, which is ultimately controlled by Mr Alisher Usmanov, and TeliaSonera Group, another major shareholder with significant influence over the Group, whose parent is a publicly owned Swedish company.

13. Related parties (continued)

The following tables provide the total amount of transactions that have been entered into with related parties and balances of accounts with them for the relevant financial periods:

	Three months ended 30 June		Six months ended 30 June	
	2014	**2013**	**2014**	**2013**
Revenues from USM Group	6	257	11	390
Revenues from TeliaSonera Group	152	161	312	246
Revenues from Euroset	20	62	44	62
	178	**480**	**367**	**698**
Services from USM Group	176	280	374	497
Services from TeliaSonera Group	526	233	866	445
Services from Euroset	317	236	706	330
	1,019	**749**	**1,946**	**1,272**

	30 June 2014	**31 December 2013**
Due from USM Group	50	20
Due from TeliaSonera Group	122	72
Due from Euroset	277	184
	449	**276**
Due to USM Group	27,326	60,275
Due to TeliaSonera Group	227	149
Due to Euroset	42	293
	27,595	**60,717**

Terms and conditions of transactions with related parties

Outstanding balances as of 30 June 2014 and 31 December 2013 are unsecured. There have been no guarantees provided or received for any related party receivables or payables. As of 30 June 2014 and 31 December 2013, the Group has not recorded any impairment of receivables relating to amounts owed by related parties.

USM Group

The outstanding balances and transactions with USM Group relate to operations with Garsdale, the Group's parent, USM Holdings Limited, an indirect owner of Garsdale, and their consolidated subsidiaries.

Amounts due to USM Group mainly represent the convertible debt instrument related to its investment in Euroset made in 2012 *(Note 8)* and the deferred consideration for the Scartel acquisition (*Note 8*).

13. Related parties (continued)

In 2012 the Group became a member of the not-for-profit partnership "Development, Innovations, Technologies" (the "Partnership") which was established by companies in the USM Group. The Partnership may determine to incur education, science and other social costs as well as to maintain certain social infrastructure assets in Skolkovo Innovation Centre which are not owned by MegaFon and not recorded in the consolidated statement of financial position. The Group's contributions to the Partnership of 1,089 during the six months ended 30 June 2014 and nil during the six months ended 30 June 2013, are included into other non-operating expenses in the interim condensed consolidated statement of comprehensive income.

TeliaSonera Group

The outstanding balances and transactions with TeliaSonera Group relate to operations with various companies in that Group. Revenues and cost of services principally related to roaming agreements between MegaFon and members of the TeliaSonera Group located outside Russia and a wireline interconnection agreement with TeliaSonera International Carrier Russia.

Euroset

Beginning from December 2012, Euroset is the Group's joint venture with OJSC VimpelCom. In December 2012 the Group entered into a dealership agreement with Euroset which qualifies as a related party transaction.

14. Commitments, contingencies and uncertainties

Operating environment

Russia continues economic reforms and development of its legal, tax and regulatory frameworks as required by a market economy. The future stability of the Russian economy is largely dependent upon these reforms and developments and the effectiveness of economic, financial and monetary measures undertaken by the government. Management believes it is taking appropriate measures to support the sustainability of the Group's business in the current circumstances.

During the six months ended 30 June 2014 economic and political instability in Ukraine increased significantly. The Group's assets in the Ukraine are essentially insignificant, so that its direct exposure to events in Ukraine is minimal. However, the Group could be affected, perhaps adversely, by sanctions imposed by the US, EU and other countries in response to the situation in Ukraine. The Group is monitoring and assessing the situation in Ukraine closely and is in the process of implementing a number of measures in order to minimise the effects of the possible risks arising out of the Ukrainian instability in general and the imposition of sanctions in particular.

4G/LTE licence capital commitments

In July 2012, the Federal Service for Supervision in Communications, Information Technologies and Mass Media granted the Group a licence and allocated frequencies to provide services under the 4G/LTE standard in Russia.

14. Commitments, contingencies and uncertainties (continued)

Under the terms and conditions of this licence, the Group is obligated to provide 4G/LTE services in each population center with over 50,000 inhabitants in Russia by 2019. The Group is also obligated to make capital expenditures of at least 15,000 annually toward the 4G/LTE roll-out until the network is fully deployed, to clear frequencies currently allocated to the military at its own cost and to compensate other operators for surrendering frequencies in an aggregate amount of 401. In 2012, the Group has fully paid the compensation due to the other operators. It is currently not able to reasonably estimate the amount of the cost of clearing military frequencies.

Huawei agreement

In April 2014, the Group entered into a 7-year agreement with Huawei Technologies Co ("Huawei") to purchase equipment and software for 2G/3G/LTE network construction and modernisation. The software usage agreement contains various termination options, however the Group is specifically committed under the agreement to pay at least 3-years-worth of fees for each base station in use as at the date of termination after taking into account fees already paid. The amount of commitment at 30 June 2014 is 1,715.

Social infrastructure expenses

From time to time, the Group may determine to maintain certain social infrastructure assets which are not owned by the Group and not recorded in the consolidated financial statements as well as to incur education, science and other social costs. Such activities are conducted in collaboration with non-governmental charity organisations. These expenses are presented in other non-operating income/(expense) in the interim condensed consolidated statements of comprehensive income.

Taxation

Russian tax, currency and customs legislation are subject to varying interpretations and changes, which can occur frequently. Management's interpretation of such legislation as applied to transactions and activities of the Group may be challenged by the relevant regional and federal authorities. Recent events within Russia suggest that the tax authorities are taking a more assertive position in their interpretation and enforcement of the legislation and assessments and as a result, it is possible that transactions and activities that have not been challenged in the past may now be challenged. Therefore, significant additional taxes, penalties and interest may be assessed. Fiscal periods remain open to review by the authorities in respect of taxes for the three calendar years preceding the current year. Under certain circumstances reviews may cover longer periods.

The Group's management believes that its interpretation of the relevant legislation is appropriate and is in accordance with the current industry practice and that the Group's tax, currency and customs positions will be sustained. However, the interpretations of the relevant authorities could differ.

14. Commitments, contingencies and uncertainties (continued)

As of 30 July 2014 the Group's management estimated the possible effect of additional taxes, before fines and interest, if any, on these interim condensed consolidated financial statements, if the authorities were successful in enforcing different interpretations, in the amount of up to approximately 877.

Litigation

The Group is not a party to any material litigation, although in the ordinary course of business, some of the Group's subsidiaries may be party to various legal and tax proceedings, and subject to claims, certain of which relate to the developing markets and evolving fiscal and regulatory environments in which they operate. In the opinion of management, the Group's and its subsidiaries' liabilities, if any, in all pending litigation, other legal proceedings or other matters, will not have a material effect on the financial condition, financial performance or liquidity of the Group.

15. Events after the reporting date

On 9 July 2014, pursuant to an agreement with Garsdale made in December 2012, the Group settled the amount due to Garsdale for its interest in Euroset *(Note 8)*. The total amount due to Garsdale for its 50% interest in Euroset was $657 million (22,095 at the exchange rate as of 30 June 2014). The Group settled the amount due to Garsdale in treasury shares pursuant to an option permitting this course of action granted under the December 2012 agreement. To determine the number of shares to be transferred to Garsdale the treasury shares were valued at the weighted average market price for the Company's GDR's for the immediately preceding six-month period. Following the transaction, the number of treasury shares reduced by 22,641,056.

In July 2014 the Group signed a 3-year revolver credit facility agreement with Raiffeisenbank for up to 12,000 at fixed or floating rate. To date, no amount has been drawn under this credit facility.